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In The

Supreme Court of the United States

October Term, 1996

MILO L. PIKE and PENNY PITOU PIKE,

Petitioners,

vs.

UNITED STATES OF AMERICA

Respondent.

Petition for Writ of Certiorari to the United States Court of Appeals for the First Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED FOR REVIEW

1. Under *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988), is the motivation or purpose of the taxpayer in acquiring an asset at all relevant to determining whether the loss or gain attributed to the disposition of the asset should be treated as ordinary or capital for Federal income tax purposes? Specifically, is the motivation or purpose of the taxpayer relevant to determining whether the asset falls within the inventory exception to the definition of capital asset in 26 U.S.C. § 1221?

2. Does this Court's decision in *Arkansas Best* preclude, under any and all circumstances, the treatment of corporate securities held by a non-dealer as inventory?

TABLE OF CONTENTS

Page

Questions Presented for Review i

Table of Contents ii

Table of Cited Authorities ii

Opinions Below 1

Statement of Jurisdiction 1

Statute Involved 1

Statement of the Case 3

Reasons for Granting the Writ 6

Conclusion 23

TABLE OF CITED AUTHORITIES

Cases Cited:

Andrew Crispo Gallery, Inc. v. Commissioner, 16 F.3d 1336 (2d Cir. 1994) 21

Arkansas Best Corp. v. Commissioner, 485 U.S. 212 (1988) ..... *passim*

Barnes Group, Inc. v. United States, 697 F. Supp. 591 (D. Conn. 1988), *vacated and remanded on other grounds*, 872 F.2d 528 (2d Cir. 1989) 17

Page

Carmel v. United States, 134 B.R. 890 (Bankr. N.D. Ill. 1991) 9, 10, 11, 14

Circle K. Corp. v. United States, 23 Cl. Ct. 659 (1991) 12, 15, 16

Circle K. Corp. v. United States, 23 Cl. Ct. 665 (1991) 11

Computervision Int'l Corp. v. Commissioner, T.C.M. (P-H) 96,131 (1996) 19

Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955) 7

Dial v. Commissioner, 968 F.2d 898 (9th Cir. 1992) 14

FNMA v. Commissioner, 100 T.C. 541 (1993) 16, 17

Frederick Weisman Co. v. Commissioner, 97 T.C. 563 (1991) 12

Guardian Indus. v. Commissioner, 97 T.C. 308 (1991) 22

In re Butcher, 109 B.R. 775 (Bankr. E.D. Tenn. 1990) 11, 14, 15

In re Larson, 862 F.2d 112 (7th Cir. 1988) 14

John J. Grier Co. v. United States, 328 F.2d 163 (7th Cir. 1964) 21

Katz v. Commissioner, T.C.M. (P-H) 60,200 (1960) 20

Kemon v. Commissioner, 16 T.C. 1026 (1951) 9

Page

Schafer v. Helvering, 299 U.S. 1 (1936) 17

Swartz v. Commissioner, 876 F.2d 657 (8th Cir. 1989), *cert. denied*, 494 U.S. 1006 (1990) 11

Tollis v. Commissioner, T.C.M. (P-H) 93,063 (1993), *aff'd without opinion*, 46 F.3d 1132 (6th Cir. 1995) 22

United States v. Norton, 1996 WL 170119 (D. Mass.) 18

Statutes Cited:

26 U.S.C. § 453(b) 18

26 U.S.C. § 471 18

26 U.S.C. § 1221 ..... *passim*

26 U.S.C. § 1221(1) ..... *passim*

26 U.S.C. § 1231 18

28 U.S.C. § 1254(1) 1

28 U.S.C. § 1291 6

28 U.S.C. § 1346(a)(1) 5

Other Authorities Cited:

Treasury Regulation § 1.471-5 18

Page

APPENDIX

Appendix A — Opinion of the United States Court of Appeals for the First Circuit Dated July 12, 1996 ..... 1a

Appendix B — Order of the United States District Court for the District of New Hampshire Filed November 28, 1996 ..... 5a

Appendix C — Order of the United States Court of Appeals for the First Circuit Entered August 28, 1996 ..... 10a

OPINIONS BELOW

The opinion of the United States Court of Appeals for the First Circuit is cited as *Milo L. Pike and Penny P. Pike, Plaintiffs, Appellants, v. United States of America, Defendant, Appellee*, 88 F.3d 54 (1st Cir. 1996).

The opinion of the United States District Court for the District of New Hampshire is cited as *Milo L. Pike, et al. v. United States of America*, No. Civ. 95-40-JD, 1995 WL 812801 (D.N.H. Nov. 28, 1995).

STATEMENT OF JURISDICTION

The Petitioners seek review from the judgment of the United States Court of Appeals for the First Circuit entered on July 12, 1996. The Petitioners timely filed a petition for a rehearing. The panel of judges that rendered the decision voted to deny the petition by Order of the Court on August 28, 1996. Pursuant to Supreme Court Rule 13.1, this petition has been filed within 90 days of the denial of rehearing.

The jurisdiction of the Court is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTE INVOLVED

26 U.S.C. § 1221

> For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—
>
> **(1)** stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of

the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, a letter, memorandum, or similar property, held by—

(A) a taxpayer whose personal efforts created such property,

(B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1);

(5) a publication of the United States Government (including the Congressional Record) which is received from the United States Government or any agency thereof, other than by purchase at the price at which it is offered for sale to the public and which is held by—

(A) a taxpayer who so received such publication, or

> **(B)** a taxpayer in whose hands the basis of such publication is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such publication in the hands of a taxpayer described in subparagraph (A).

STATEMENT OF THE CASE

The Petitioners[1] claim that losses in 1989 of some $2,207,798 from sales of Pike's substantial holdings of regional bank stocks were ordinary, not capital, losses for Federal income tax purposes. Pike contends that his stock holdings were not capital assets because they constituted property within the first clause of the exemption to 26 U.S.C. § 1221 ("Section 1221") found in subsection (1) thereof, the so-called inventory exemption: "stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year."

While still the principal of Pike Industries, a multi-million dollar paving operation, Pike began to develop an interest and acquire a skill in banking. In 1964, Pike became a director of Laconia Peoples Bank & Trust and remained on the board in an active capacity until 1974, when he became a member of the Board of Directors of First NH Bank, the holding company of which Laconia Peoples Bank & Trust was a subsidiary. During his tenure on the First NH Board, Pike, who eventually became the bank's largest stockholder, became very active in reviewing, assessing and working with the C.E.O. of the bank on the many acquisitions which First NH considered or consummated. As a

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[1]The operative facts in this case involve the actions of the Petitioner Milo Pike; his wife, Penny Pike, is joined as a party merely because the parties filed joint tax returns. All references hereafter to "Pike", therefore, are to Petitioner Milo Pike.

result of this experience, Pike developed an expertise in the banking industry, including insight into the operations of banks and the advantages of consolidations and mergers.

When he sold Pike Industries for a substantial amount of money in the late 1980's, Pike had the opportunity to fulfill his desire to devote all of his time to the banking business.[2] For example, on July 22, 1988, Pike entered into a partnership agreement with another area businessman with substantial banking experience, Henry M. Powers, "to provide certain advisory services to banks, savings and loan associations, affiliates of the foregoing, other financial institutions and businesses in general with respect to mergers and acquisitions." Pike's plan was that he and one or more partners would accomplish, in essence, what had been done by First NH and subsequently by the FDIC and other governmental regulatory agencies after the collapse of New Hampshire's banking industry, i.e., create a large, regional bank holding company.

Pursuant to his banking business plan, Pike acquired several hundred thousand shares of stock in a limited number of New England banking institutions which Pike believed would result in the best combination and the greatest profit to reward his many hours of careful study and work.[3] Pike acquired the bank stocks not as "investment" assets, but as raw material to be used in his banking trade or business to create a bank holding company. At all times, he intended that the finished product would be sold to investors for a profit. Pike's bank stock purchases were not

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[2]As part of the arrangement for the sale of Pike Industries, Pike entered into a covenant not to compete within the construction industry for a period of five years after the closing of the sale.

[3]Pike's purchases of bank stocks eventually totaled some thirty-nine million dollars.

based primarily upon price and market expectations, but upon strategic considerations such as the location of the banks, their likely fit with other banks in which Pike had an interest, the number of shares required for Pike to be able to exercise influence upon management and the like. The substantial blocks of shares facilitated Pike's efforts to gain an audience with numerous bank officers and directors in order to promote his plan of merger, acquisition and consolidation.

Pike did in fact participate in many meetings with bank officers and directors to discuss mergers and consolidations. This would not have been possible but for the fact that Pike had personally acquired large blocks of stock in furtherance of his business goal. His efforts, however, were to no avail. Pike eventually realized that his plan was not going to succeed and sold his stock holdings. Unfortunately, the market for regional bank stocks had declined to such an extent that he lost almost everything.

Pike's original accountants prepared a return for the tax year 1989 reflecting his losses as capital losses. Pike subsequently amended his return and sought to treat his bank stock losses as ordinary rather than capital. The Internal Revenue Service disallowed such treatment. Pike brought an action in the United States District Court for the District of New Hampshire for the recovery of income taxes illegally and erroneously assessed and collected. Jurisdiction over the action was conferred upon the court by 28 U.S.C. §1346(a)(1).[4]

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[4]A companion action to the case at bar is presently pending in the United States Tax Court, awaiting the outcome of this case. *Pike v. Commissioner*, USTC Docket No. 11287-95. That action involves the remainder of Pike's bank stock losses, which were sustained in years subsequent to 1989. For those years, the Petitioners filed tax returns reporting their losses as ordinary losses. The IRS issued a notice of deficiency which

The Government moved for summary judgment. For purposes of the motion, the facts outlined above were accepted as true. The district court held that the issue of whether Pike's stock holdings were properly treated as capital or non-capital assets was dictated by this Court's decision in *Arkansas Best v. Commissioner*, 485 U.S. 212 (1988). Interpreting *Arkansas Best* as holding that "a taxpayer's 'motivation in purchasing an asset is irrelevant' to whether the investment falls under a statutory exception" to § 1221, the district court stated that it made no difference why Pike acquired his bank stock. Concluding that only a securities dealer could treat gains or losses from stock sales as ordinary, the court granted the Government's motion for summary judgment.

Pursuant to 28 U.S.C. § 1291, the Petitioners appealed the order of the district court to the United States Court of Appeals for the First Circuit. The court of appeals construed *Arkansas Best* the same way that the district court had and affirmed the district court's dismissal of the case on summary judgment.

REASONS FOR GRANTING THE WRIT

A. The *Arkansas Best* Decision

The United States Court of Appeals for the First Circuit erroneously interpreted *Arkansas Best* as holding that: (1) except in the hands of a dealer, corporate stock can itself *never* fit within the express terms of the statutory exceptions to § 1221 as a non-capital asset, particularly as inventory; and (2) the *only* property not within the express terms of a statutory exception to § 1221 that can be treated as a "substitute" for such property is property "acquired in a hedging transaction that was an integral part of a business inventory-purchase system." *Pike*, 88 F.3d at 55. Since Pike's stock purchases were not inventory hedges, this

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categorized the losses as capital.

interpretation precluded the court from examining Pike's assertion that his motivation and purpose in acquiring bank stocks brought those assets within the ambit of the inventory exception to § 1221.

While courts within some federal circuits have interpreted *Arkansas Best* in a manner similar to the First Circuit, courts from other federal circuits have decided that the case *does* allow the ordinary income treatment of stock in the hands of a non-dealer, and that the proposition that a taxpayer's motivation or purpose may qualify otherwise capital assets as non-capital surrogates for one of the statutory exceptions is *not* limited to inventory hedges. This Court should grant the writ to resolve this split between circuits and to correct the First Circuit decision in the instant case.

As the analysis by this Court in *Arkansas Best* reveals, the determination of whether to treat an asset as a capital asset under § 1221 involves two steps. In the words of the statute, the first inquiry is whether the asset is "property held by a taxpayer (whether or not connected with his business)." 26 U.S.C. § 1221. The clear language of the parenthetical phrase served as the basis for this Court to "conclude that a taxpayer's motivation in purchasing an asset is irrelevant to the question whether the asset is 'property held by a taxpayer (whether or not connected with his business)' and is thus within § 1221's general definition of 'capital asset.'" *Arkansas Best*, 485 U.S. at 217, 223. Instead, so held this Court, the five enumerated exceptions in § 1221 are exclusive.

In *Arkansas Best*, therefore, this Court attempted to rein in and redirect courts which were expanding the so-called *Corn Products* doctrine. *See generally, Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955). This Court held that the statutorily enumerated exceptions to the definition of capital asset in §1221 are exclusive and may not be judicially expanded simply on the basis of findings that there is some relationship between a

taxpayer's property and his trade or business.

However, this Court expressly acknowledged that as to the second inquiry which exists under § 1221—i.e., whether any of the statutory exceptions apply—the taxpayer's motivation or purpose *is* relevant.

> A business connection, although irrelevant to the initial determination whether an item is a capital asset, is relevant in determining the applicability of certain of the statutory exceptions, including the inventory exception. The close connection between the futures transactions and the taxpayer's business in *Corn Products* was crucial to whether the corn futures could be considered surrogates for the stored inventory of raw corn.

Arkansas Best, 485 U.S. at 221. On the other hand, since the taxpayer in that case did not claim that its property fell within one of the specific statutory exceptions, this Court held that the property at issue, which consisted of the securities of another entity, was a capital asset for purposes of determining whether or not its sale generated a capital or an ordinary loss for income tax purposes.

Simply stated, therefore, *Arkansas Best* holds that property falls within the grasp of § 1221 regardless of the taxpayer's motivation or purpose, but a court may consider that motivation or purpose when applying the exceptions to the statute.

B. Pike's Claim

An elaboration of Pike's position should help to narrow and clarify the present issues. Pike was neither type of taxpayer whose stock holdings have traditionally been held to qualify as capital assets:

1) he was not an "investor", who derives profits from the interest, dividends and capital appreciation of securities,

usually based upon long-term growth;
2) nor was he a "trader", who is in the business of trading securities and generally derives profits from the direct management of purchasing and selling such securities, usually based upon short-term market swings.

See generally, Carmel v. United States, 134 B.R. 890, 901 (Bankr. N.D. Ill. 1991); *Kemon v. Commissioner*, 16 T.C. 1026, 1032 (1951).

On the other hand, Pike was also not the type of taxpayer whose stock holdings have traditionally been held to qualify as ordinary assets. Pike was not a "dealer" in securities since he was not generally in the business of buying and selling securities with the purpose of realizing a transactional profit as a middleman or broker. *See Kemon*, 16 T.C. at 1032.

Nevertheless, Pike does claim his bank stock holdings were ordinary, not capital, assets. Specifically, Pike claims that they came within the ambit of the inventory exception to § 1221, as follows:

a) Pike was engaged in the business of building a product, a regional bank holding company, and the profits that he hoped to realize would be generated by the value added from his labors, not as a result of market fluctuations in the individual stocks he was acquiring;
b) the bank stocks which he purchased were the raw materials, or inventory, for the finished product he expected to create and which he then intended to sell to customers; and/or
c) his bank stocks were "surrogates" for the underlying bank assets, which in turn were the inventory for his proposed finished product, a bank holding company.

To the First Circuit and other courts which agree with it, Pike's stock holdings could never qualify as ordinary assets since business purpose is only relevant when the asset acquisition is a hedging transaction which is an integral part of an inventory-

purchase system and, in any case, corporate stock held by a non-dealer is, *per se*, a capital asset. To other courts, however, Pike's business purpose could be a factor in determining whether his stock holdings qualify under a statutory exemption to § 1221 and, further, there is no *per se* bar from those exemptions for stock.

C. May Corporate Stock Ever Be Treated as an Ordinary Asset in the Hands of a Non-Dealer?

The First Circuit in the instant case stated that in *Arkansas Best* this Court

> ruled that stock in a local bank acquired for the business-related purpose of preserving the taxpayer's financial reputation, *id.* at 215, 108 S. Ct. at 973, fell "outside the classes of property excluded from capital-asset status" under § 1221, thus the loss arising from its sale was "a capital loss." *Id.* at 223, 108 S. Ct. at 978.

Pike v. United States, 88 F.3d 54, 55 (1st Cir. 1996). *Arkansas Best*, however, did not deal with whether stock could fit within the "classes of property excluded from capital asset status under § 1221"; it only held that the classes listed in the statute could not be expanded by the courts. Since the Arkansas Best Corporation never claimed that its stock holdings qualified for one of the statutory exemptions, this Court never examined the possibility that stocks held by a non-dealer could qualify for one of those exemptions.

Nevertheless, the First Circuit is not alone in its belief that *Arkansas Best* did reach this issue and resolved it in the negative. The supposed *per se* capital asset status of stocks in the hands of non-dealers was also asserted by a bankruptcy court in the seventh circuit. In *Carmel v. United States*, 134 B.R. 890 (Bankr. N.D. Ill. 1991), the court determined that since the taxpayer in that case was a trader in securities, he could have no meritorious argument under the inventory exception, which the

court expressly referred to as the "dealer-inventory" exception:

> Under the literal language of § 1221, property used in connection with a trade or business will be treated as a capital asset unless it is held as inventory *by a dealer* in such property.
>
> . . . .
>
> . . . In *Arkansas Best Corporation v. Commissioner*, . . . , the Supreme Court . . . held that the *dealer-inventory* exception to the definition of a capital asset does not include property which is acquired and held for a business purpose.

Id. at 901-02 (emphasis added).

In re Butcher, 100 B.R. 363 (Bankr. E.D. Tenn. 1989), a bankruptcy court decision from the sixth circuit, is even more succinct in its statement of the proposition. "*Arkansas Best* mandates the treatment of bank stock, such as that purchased by the [taxpayer], as a capital asset for tax purposes." *Id.* at 372; *see Swartz v. Commissioner*, 876 F.2d 657 (8th Cir. 1989), *cert. denied*, 494 U.S. 1006 (1990) (holding that commodity futures contracts are *per se* capital assets in the hands of a non-dealer).

The United States Claims Court, however, has taken the contrary position to that of the First Circuit in *Pike*. *See Circle K Corp. v. United States*, 23 Cl. Ct. 659 (1991) and 23 Cl. Ct. 665 (1991). The taxpayer, which operated convenience stores—many of which sold gasoline—had purchased and sold stock in an oil company. The taxpayer was clearly not a dealer in oil stocks. However, the court found that since the stock purchases were accompanied by options to purchase crude oil, the transactions were so closely related to the taxpayer's business that the stocks could be treated as ordinary assets. In clarifying its original order in the case, the court stated that:

> [The Government] argued that, after *Arkansas Best*, plaintiff's stock purchases never could receive ordinary asset treatment. [This] court decided that, as a matter of law, they could.
>
> . . . .
>
> . . . [L]ike the commodity futures in *Corn Products*, the stock options here could be viewed, as a matter of law, as surrogates for raw product because of the close connection between gasoline and plaintiff's business. That is exactly the analysis the Supreme Court endorsed in *Arkansas Best*.

23 Cl. Ct. 659, 662, 664.

In another non-dealer case, the United States Tax Court also left open the possibility that stocks could be treated as ordinary assets under the right circumstances.

> As *Arkansas Best Corp. v. Commissioner*, . . . has made clear, [an inquiry into the taxpayer's motivation] is appropriate only to determine if a particular asset comes within the inventory exception to the statutory definition of capital asset. The stock purchase *in this case* was clearly not a surrogate for petitioner's inventory items.

Frederick Weisman Co. v. Commissioner, 97 T.C. 563, 573 n.4 (1991) (emphasis added). The court thus implies that there may be a proper case in which stocks *can* be inventory or an inventory-surrogate.

D. Is Taxpayer Motivation or Purpose Generally Relevant to Determining the Character of Property Which Does Not Itself Qualify for One of the Statutory Exceptions of 26 U.S.C. § 1221 But Which Serves as a "Surrogate" for Assets Within an Exception; or Did *Arkansas Best* Limit Such an Inquiry to Hedges Which Are an Integral Part of an Inventory-Purchase System?

The First Circuit held that this Court's interpretation in *Arkansas Best* of the *Corn Products* case limited inquiry into taxpayer motivation or purpose only to situations identical to that presented in *Corn Products*.

> In determining whether property qualifies for exclusion from capital asset treatment, the Supreme Court has indicated that a taxpayer's business purpose is relevant *only* in the very narrow circumstance wherein an otherwise non-inventory asset may be regarded as a *substitute* for inventory—i.e., property acquired in a "hedging transaction[] that [was] an integral part of a business' inventory-purchase system."

Pike, 88 F.3d at 55 (quoting *Arkansas Best*, 485 U.S. at 221-22) (emphasis and alterations in original). Since it was acknowledged that Pike's stock purchases were not part of an inventory-hedging program, the court held that Pike's motivation or purpose was irrelevant to determining whether his bank stocks qualified as ordinary assets within the inventory exception. *Id.*

The United States Court of Appeals for the Ninth Circuit has expressly limited *Arkansas Best* in the same way:

> Only futures contracts guaranteeing or requiring delivery of the taxpayer's stock in trade or other property properly included in the taxpayer's inventory may be excepted from capital-asset treatment under *Arkansas Best*. Business purpose is not relevant to the

determination whether property is a capital asset.

Dial v. Commissioner, 968 F.2d 898, 901 (9th Cir. 1992). Since the taxpayer's futures transactions in that case were not for the purpose of assuring a supply of raw materials or protecting against fluctuations in the market price of a commodity, the court held that any other business motivation or purpose was irrelevant to the application of the inventory exception. *Id.* at 902.

The United States Court of Appeals for the Seventh Circuit has also applied this narrow interpretation of *Arkansas Best*. *In re Larson*, 862 F.2d 112 (7th Cir. 1988). After quoting this Court's language describing the holding of *Corn Products* as an application of the inventory exception to § 1221, the court stated that since the taxpayer's stock holdings were not part of a hedging transaction, they were "clearly not within the inventory exception." *Id.* at 118.

The bankruptcy court decision from the seventh circuit mentioned earlier, *Carmel*, expressed the same view about *Arkansas Best*'s supposed limitation upon considerations of taxpayer motivation to inventory hedges:

> The [Supreme] Court also stated in *Arkansas Best* that the *Corn Products* doctrine is properly interpreted as standing for the narrow proposition that only those hedging transactions which are an integral part of the business-inventory purchase system fall within the inventory exclusion of § 1221. The Debtor here is not involved in hedging transactions so that the *Corn Products* doctrine is literally not applicable.

Carmel, 134 B.R. at 902 n.7 (citations omitted).

Likewise, *In re Butcher*, the bankruptcy court decision from the sixth circuit, also discussed earlier, stated that:

> The Supreme Court in *Arkansas Best* specifically limited application of the doctrine enunciated in *Corn Products* to "hedging transactions that are an integral part of a business' inventory-purchase system . . . ."

100 B.R. at 371.

At the far end of this swing of the pendulum is the case of *Circle K Corp. v. United States*, 23 Cl. Ct. 659 (1991). In that case, the United States Claims Court declared that taxpayer motivation and purpose are irrelevant to *all* the statutory exceptions and under *all* circumstances, *including hedging transactions*.

> *Arkansas Best* severely limited *Corn Products* by prohibiting any kind of initial intent inquiry. As is apparent, the court no longer may ask whether the purchase was made with a "business purpose," but the court does not read *Arkansas Best* as stopping there. *Arkansas Best* specifically affirmed the Eighth Circuit's holding that a taxpayer's "purpose in acquiring and holding stock [is] irrelevant to the determination whether the stock was a capital asset."

Id. at 664 (alteration in original).

Supposedly ignoring the taxpayer's intent in the case before it, the claims court nevertheless found a "close connection" between the taxpayer's stock purchases and its business and held that the stock should be treated as ordinary assets.

> The court compared plaintiff's situation to that of the plaintiff in *Corn Products* and determined that, like the commodity futures in *Corn Products*, the stock options here could be viewed, as a matter of law, as surrogates for raw product because of the close connection between gasoline and plaintiff's business.

> That is exactly the analysis the Supreme Court endorsed in *Arkansas Best*.

Id. at 664.

On the other side of the fence, the United States Tax Court and a district court from the second circuit have disagreed with the limitations imposed by the above courts on the relevance of taxpayer purpose.

In *FNMA v. Commissioner*, 100 T.C. 541 (1993), the court noted that although this Court stated in *Arkansas Best* that the reach of § 1221's capital asset definition is broad, this Court did not overrule *Corn Products* and, accordingly, that the reach of § 1221's exceptions is likewise broad.

> [A]s the [Supreme] Court affirms at several points, the exceptions under section 1221 may be broadly interpreted, and thus property (e.g., futures), even though it does not fall literally within any of the exceptions, may be so related to other property excepted in the statute (e.g., inventory) that it should receive ordinary treatment as well.

Id. at 573-74.

In that case, "Fannie Mae" had claimed that its holdings of mortgages acquired in the secondary mortgage market were ordinary, not capital, assets. Although FNMA's mortgages did not "fit under any literal application of the statutory exceptions," the court found that FNMA's business purposes in acquiring the mortgages brought them under § 1221(4), the notes receivable exception. In so finding, the court rejected the government's argument that where property does not come within a statutory exception, it may only qualify for ordinary treatment if it:

(1) is an integral part of the taxpayer's inventory

> purchase system; and (2) is capable of treatment as a "substitute" or "surrogate" for inventory (that is behaves economically just like the inventory).

Id. at 575. Rather, the court stated that

> Although the Supreme Court concluded that *Corn Products* involved the inventory exception, the Supreme Court did not preclude ordinary treatment for gains or losses from disposition of assets that were integrally related to other exceptions in section 1221.

Id. at 576.

In *Barnes Group, Inc. v. United States*, 697 F. Supp. 591 (D. Conn. 1988), *vacated and remanded on other grounds*, 872 F.2d 528 (2d. Cir. 1989), the district court found the taxpayer's motivation in currency exchange transactions irrelevant since the taxpayer never argued that the contracts qualified directly under a statutory exception nor as a surrogate for property within an exception. Notably, the court did not restrict its discussion of "surrogates" to inventory or to hedging transactions. Rather the court stated that motive may be relevant if the taxpayer "establishes the asset in question as a surrogate for *one of* the statutory exceptions to capital-asset treatment." *Id.* at 597 n.7 (emphasis added).

E. The First Circuit Erroneously Held That Pike's Stock Holdings Could Not Be Inventory Because He Was Not a Dealer in Securities.

The First Circuit made an *a priori* decision in this case that corporate securities *cannot* be inventory.[5] Nowhere in the court's

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[5]Except, of course, for securities held by dealers. *See e.g., Schafer v. Helvering*, 299 U.S. 1 (1936). On the other

opinion, however, is there a discussion of what § 1221(1) means by the language "property of a kind which would properly be included in the *inventory* of the taxpayer if on hand at the close of the taxable year." (emphasis added)

Section 1221(1) does not itself define the term "inventory". Indeed, although the term is often used therein, it is not defined anywhere in the Internal Revenue Code. *See, e.g.*, 26 U.S.C. § 471; 26 U.S.C. § 453(b); 26 U.S.C. § 1231. To the extent, therefore, that the First Circuit simply asserts that Pike's holdings of securities do not qualify as inventory under § 1221(1), such a conclusion is a product of judicial fiat, not reasoned decision.

The closest that one gets to a definition of "inventory" is a passage found in Treasury Regulation 1.471-1:

> [I]nventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale . . . .

(Emphasis supplied.) This distinction between a finished product

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hand, securities in the hands of a dealer, although often categorized as "inventory", are clearly exempted from capital asset designation under the second clause of § 1221(1) as being "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." Whether securities dealers may also be exempted under the first clause of § 1221(1) as holders of inventory is seemingly an issue of no consequence because, in either case, the determining factor for dealers has been defined by both the IRS and the courts as whether or not the taxpayers hold their securities for sale to customers. *See* Treasury Regulation § 1.471-5; *United States v. Norton*, 1996 WL 170119 (D. Mass.).

and raw materials or work-in-process, of course, is just the concept which the Pike claims applies to his bank stocks.[6] The First Circuit acknowledged Pike's raw materials contention, but it then just assumed (without any discussion) that securities cannot be this type of inventory. *Pike*, 88 F.3d at 55.

Neither § 1221(1) nor *Arkansas Best* prescribes any such *per se* rule. The Petitioners are entitled to a trial in which the economic realities of his transactions are explored and a factual determination is made as to whether his stock holdings were or were not "inventory". For example, in the recent case of *Computervision International Corp. v. Commissioner*, T.C.M. (P-H) 96,131 (1996), the United States Tax Court concluded that the sale of the stock warrants which the taxpayer had received in connection with the purchase of computer workstations from its supplier, Sun Microsystems, did not constitute the sale of a capital asset, but instead represented a discount on the price of the taxpayer's workstation inventory. T.C.M. (P-H) 96-131, at 21-23. In that regard, the court specifically noted that the fact that the transaction involved a "form of property that may ordinarily be considered a capital asset" would not prevent the court from looking at all of the facts and circumstances surrounding the transaction in order to determine its proper tax treatment. *Id.* at 22.

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[6]In this regard, the Pike's use of the term "inventory-like" to describe his bank stocks was not meant to imply any acknowledgment that the property was outside the confines of § 1221 in the sense of the old *Corn Products* doctrine, but only to recognize the fact that his claim that corporate securities were a type of raw material was somewhat different from the conventional notion of what constitutes "inventory".

F. If the Proper Test for Determining Whether Securities Held by a Non-Dealer Are Inventory Is Whether They May Be Considered "Substitutes" for Inventory, the First Circuit Was Clearly in Error in Excluding Considerations of Pike's Business Purpose in Acquiring His Stocks From the Determination of Whether or Not He Met the Test.

In its discussion of *Arkansas Best*, the First Circuit noted that hedging transactions involve property which would not itself qualify as inventory and is only so qualified because it was acquired as a "substitute" for inventory. *Pike*, 88 F.3d at 55. On the other hand, the court holds that hedging transactions are the *only* types of inventory substitutes which qualify for § 1221(1) treatment.

As noted above, this is not the holding of *Arkansas Best*. For example, it would eliminate the source-of-supply line of cases represented by *Circle K Corp. v. U.S.*, *supra*. Such cases are based upon the proposition that the acquisition of a company which produces what the taxpayer sells as inventory is the acquisition of a "substitute" for the inventory itself. These cases quite sensibly extend ordinary income treatment to taxpayers whose purpose is simply to guarantee a supply of product as opposed to creating a hedge against price increases.

Although Pike's holdings of securities were not, as the First Circuit notes, "a 'hedge' integral to protecting inventory or an inventory-purchase system," this does not preclude them from being some other kind of inventory-substitute. Indeed since banks are the raw material of a bank conglomerate, Pike's purchases of stocks in individual banks in order to create a bank holding company can be viewed as the acquisition of "substitutes" for an inventory of banks.

This was, in essence, the reasoning of the Tax Court in *Katz v. Commissioner*, T.C.M. (P-H) 60,200 (1960), a pre-*Arkansas*

Best case. The taxpayer in that case held stock in various corporations formed solely to acquire, develop and sell luncheonettes. Because the taxpayer could "as easily be said to have sold the equipped luncheonettes and leaseholds as the stock in the eight corporations which held title to the fixtures and in whose names the leases were taken," the court "disregarded the corporate entity" and held that the stocks were inventory assets, not capital assets, and, thus, their sale generated ordinary income. *Id.* at 10; *see also John J. Grier Co. v. United States*, 328 F.2d 163 (7th Cir. 1964).

Indeed, it would seem obvious that unless one assumes that certain types of property are *per se* capital assets or ordinary assets (which, as argued above, is not the case), one cannot determine which they are in any given case unless one considers the taxpayer's intent/purpose/motivation in acquiring those assets.

This is clearly the view of at least the Second Circuit and the United States Tax Court. For example, in *Andrew Crispo Gallery, Inc. v. Commissioner*, 16 F.3d 1336 (2d Cir. 1994), the issue was whether paintings which had originally been acquired by the taxpayer, an art gallery, for purposes of sale to customers in the ordinary course of business had changed their character and become capital assets when they were seized by creditors and eventually sold at auction to satisfy liens. The Second Circuit held that, to determine the character of an asset, the court should examine how and why the taxpayer is holding the asset as of the time of disposition. The reason is that the taxpayer's *intent*, which is the critical issue, might change during the time between acquisition and disposition.

The United States Tax Court has been even more direct in its statement of the relevance of intent to determining the character of an asset.

> The controlling factor in determining the character of the [asset] is the purpose for which it is held, which is

> to be determined at the time of sale, although we may consider events occurring prior to such time in order to identify such purpose.

Guardian Industries v. Commissioner, 97 T.C. 308, 316 (1991). And to the extent that taxpayer intent or purpose is a relevant factor, it is "a question of fact that is to be determined on a case-by-case approach." *Tollis v. Commissioner*, T.C.M. (P-H) 93,063 (1993), *aff'd without opinion*, 46 F.3d 1132 (6th Cir. 1995).

In the instant case, the Government's summary judgment motion accepts as true the fact that Pike's intent was to acquire bank stocks as the raw material for the creation of a bank holding company, and not for investment purposes. Consequently, unless corporate stocks can only be treated as inventory in the hands of a dealer—which Pike admittedly was not—the Petitioners should be permitted to attempt to prove their claim that Pike's holdings were indeed "surrogates" for inventory and, therefore, ordinary assets for the purpose of computing gains or losses on their sale.

CONCLUSION

Arkansas Best was meant to curb the judicial creation of non-statutory exceptions to the definition of capital asset in the Internal Revenue Code which had been engendered by an expansive reading of the *Corn Products* case. That was accomplished. On the other hand, this Court expressly endorsed *Corn Product*'s broad interpretation of the statutory exceptions to the definition. As reflected in the case at bar, however, many lower courts have ignored that aspect of *Arkansas Best* and have, instead, constricted the exceptions as well. As a result, irrespective of the facts of the case, taxpayers such as the Petitioners have been prevented from even attempting to show that certain types of property, here bank stock, was acquired and held by them for business purposes fairly contemplated by a generous reading of those statutory exceptions.

For the reasons stated, the petition for a writ of certiorari should be granted.

Dated: November 22, 1996

Respectfully submitted,

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APPENDIX A - OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT DATED JULY 12, 1996

UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

No. 95-2358

MILO L. PIKE and PENNY P. PIKE,
Plaintiffs, Appellants,
v.
UNITED STATES OF AMERICA,
Defendant, Appellee.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF NEW HAMPSHIRE

[Hon. Joseph A. DiClerico, Jr., U.S. District Judge]

Before
Cyr, Circuit Judge,
Aldrich, Senior Circuit Judge,
and Gertner,* District Judge.

Eugene M. Van Loan, III with whom Richard Thorner and Wadleigh, Starr, Peters, Dunn & Chiesa were on brief for appellants.

Thomas V.M. Linguanti with whom Gary R. Allen, Jonathan S. Cohen, Attorneys, Tax Division, Department of Justice, Loretta C. Argrett, Assistant Attorney General, and Paul M. Gagnon, United States Attorney, were on brief for appellee.

July 12, 1996

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*Of the District of Massachusetts, sitting by designation.

ALDRICH, Senior Circuit Judge. This case involves the government's familiar income tax principle of taxing gains in the sale or exchange of capital assets but disallowing deduction of losses, except against comparable taxable gains. See 26 U.S.C. §1211. During the 1980s, Milo Pike ("Taxpayer") made substantial purchases of stock in a number of New England banks with the intent of creating a regional bank holding company, whose stock he could sell at a profit. Before realizing this goal, however, the shares universally declined in value and, in 1989, he sold them at a substantial loss. He classified the loss as "capital" on his 1989 federal tax return, which precluded deduction in full. See id. In this action to recover taxes overpaid, Taxpayer claims his special scheme and purpose for making the purchases requires that the stock be classified as "inventory," a non-capital asset under 26 U.S.C. 1221(1), entitling him to full deduction. The Commissioner did not agree. Nor did the district court. Taxpayer appeals. We affirm.

Under §1221 of the Revenue Code all taxpayer property not qualifying for a specific exception, whether or not held in connection with the taxpayer's trade or business, is deemed capital. Five "exclusive" categories are excepted, Arkansas Best Corp. v. Commissioner, 485 U.S. 212, 217-18 (1988), including

> (1) Stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

26 U.S.C. §1221(1). Taxpayer does not contend that the bank shares were "stock in trade," nor that he was holding them for sale to customers in the ordinary course of his business, nor that they can be exempted under any of the other four provisions of 1221. He does not even claim that the stock was "inventory" in the usual sense. He nonetheless claims that summary judgment was

improper because there remain unresolved issues of material fact as to whether the stock was sufficiently "inventory-like" to qualify for exemption from capital asset status under the above-quoted exception, based on his intent in acquiring it. We disagree.

In determining whether property qualifies for exclusion from capital asset treatment, the Supreme Court has indicated that a taxpayer's business purpose is relevant only in the very narrow circumstance wherein an otherwise noninventory asset may be regarded as a substitute for inventory -- i.e., property acquired in a "hedging transaction[] that [was] an integral part of a business' inventory-purchase system." Arkansas Best, 485 U.S. at 221-22 (explicitly narrowing Corn Products Refining Co. v. Commissioner, 350 U.S. 46, 52-53 (1955)). Even then there must be some objectively demonstrable nexus to an "inventory-purchase system," beyond the taxpayer's subjective intent. Id. at 221, 222. In Arkansas Best, the Court ruled that stock in a local bank acquired for the business-related purpose of preserving the taxpayer's financial reputation, id. at 215, fell "outside the classes of property excluded from capital-asset status" under §1221, thus the loss arising from its sale was "a capital loss." Id. at 223. Here, Taxpayer's project was to purchase enough shares of stock in certain banks sufficient to obtain the ability to persuade management to join in his plan of forming the overall holding company, whose stock he would then sell. He claims the bank stock was the "raw material" in his business of building the holding company and, as such, qualifies for the inventory exception.

Overall, Taxpayer was simply seeking capital gains by an intermediate step -- acquiring enough capital investments, that, jointly, might be converted into new assets. His scheme was manifestly not a "hedge" integral to protecting inventory or an inventory-purchase system. That it involved work on his part and was necessary to his overall business plan does not change the basic picture. His theory that the building blocks of his would-be empire should qualify as "inventory" would allow aspiring entrepreneurs

significant influence over whether losses receive capital or ordinary treatment. Id. at 222. An ordinary investor in capital stock, objectively not entitled to take losses not offset by gains, could do so if he could show a business-related motive to realize gains through conversion and disposition of those assets. Such an alluring door for escaping taxpayers was firmly locked in Arkansas Best.

Affirmed.

APPENDIX B - ORDER OF THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF NEW HAMPSHIRE FILED NOVEMBER 28, 1995

UNITED STATES DISTRICT COURT FOR THE DISTRICT OF NEW HAMPSHIRE

Milo L. Pike, et al.

v. Civil No. 95-40-JD

United States of America

ORDER

The plaintiffs, Milo Pike and Penny Pike, bring this action against the defendant, the United States of America, to recover $438,262 in income taxes the plaintiffs assert were erroneously collected in 1989. The plaintiffs claim that losses from the sale of certain bank stock were incorrectly characterized as capital losses rather than as an ordinary business losses. Before the court is the United States' Motion for Summary Judgment (document no. 6).

Background[1]

Since 1964, Milo Pike acquired substantial experience in the banking industry, particularly in the area of consolidations and mergers. Complaint at ¶¶ 6, 9. During the 1980s Pike formulated a plan to establish a major bank holding company. Id. at ¶ 12.

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[1]The court's recitation of the facts relevant to the instant motion are either not in dispute or have been alleged by the plaintiffs.

Toward this end he "acquired several hundred thousand shares of stock in a limited number of New England banking institutions which Pike believed would result in the best combinations and the greatest profit to reward his many hours of careful study and work." Id. at ¶ 14. At all times Pike intended "to develop a finished product which could be sold to investors for a profit." Affidavit of Milo Pike ("Pike Affidavit") at ¶ 3A.

Pike selected banks for his portfolio based on what he considered to be strategic considerations such as location, the likely "fit" with other banks in which he held an interest, and the number of shares needed to influence existing management. Pike Affidavit at ¶ 3B. Pike was not primarily concerned with price and market expectations. Id. The purchase of substantial blocks of stock allowed Pike access to and influence over bank officers and directors in order to promote his plans of merger, acquisition, and consolidation. Id. at ¶ 3C.

The value of Pike's bank holdings declined substantially in the late 1980s with the downturn in the New England economy. Complaint at ¶ 14. The ultimate sale of these stocks resulted in losses that were reported on the plaintiffs' 1989 federal tax return as "capital" losses. On or about March 22, 1992, the plaintiffs filed an amended 1989 tax return to re-characterize the losses from "capital" to "ordinary." The Internal Revenue Service disallowed the requested refund on the ground that the losses were properly treated as capital losses.

Discussion

The court applies the usual summary judgment standard. See, e.g., Snow v. Harnischfeger CorP., 12 F.3d 1154, 1157 (lst Cir. 1993), cert. denied, 115 S. Ct. 56 (1994) (quoting Wynne v. Tufts Univ. Sch. of Medicine, 976 F.2d 791, 794 (lst Cir. 1992), cert. denied, 113 S. Ct. 1845 (1993)).

In its motion, the government asserts that as a matter of law the losses resulting from Pike's sale of his bank stock yielded "capital" losses as that term is defined by the tax code. Defendant's Motion for Summary Judgment at 1-2 (citing 26 U.S.C. § 1221; Arkansas Best Corp. v. Commissioner, 485 U.S. 212 (1988)).

Pike responds that his bank stock constitutes "inventory" and, therefore, falls within an enumerated exception to the capital stock statute. Plaintiffs' objection to Summary Judgment at 3 (citing 26 U.S.C. § 1221(1)). The plaintiffs argue that the determination of whether the stock satisfies the claimed exception is a question of fact properly resolved at trial. They further assert that the investments were not purchased for "market expectations" or capital appreciation but, rather, were intended to create the access to bank management necessary to merge or consolidate several smaller banks into a major holding company. Pike Affidavit at ¶ 3 (A-D).

The instant motion turns on the application of 26 U.S.C. § 1221 to the facts taken in a light most favorable to the plaintiffs. The statute defines the term "capital asset" as

> property held by the taxpayer (whether or not connected with his trade or business), but does not include -
>
> (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business[2]

26 U.S.C.A. § 1221 (West 1988).

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[2]Neither party has suggested the application of one of the four other exceptions to § 1221. See 26 U.S.C. § 1221(2) - (5).

The definition of "capital asset" in § 1221 has been interpreted broadly. Arkansas Best Corp. v. Commissioner, 485 U.S. 212, 215-16 (1988). The five listed exceptions, including that for inventory, are considered "exclusive" rather than "illustrative," id. at 217-18, and, accordingly, have been construed narrowly according to the plain meaning of the statutory language, see id. at 216, 218-19, 223. The Supreme Court has held that a taxpayer's "motivation in purchasing an asset is irrelevant" to whether the investment falls under a statutory exception to the § 1221 rule that property is a "capital asset." Id. at 223.

The purpose of the inventory exception, 26 U.S.C. § 1221(1), is to "differentiate between the 'profits and losses arising from the everyday operation of a business' on the one hand . . . and 'the realization of appreciation in value accrued over a substantial period of time' on the other." Tollis v. Commissioner, 1993 WL 46522 (U.S. Tax Ct.), 65 T.C.M. (CCH) 1951 (Feb. 24, 1993). Securities cannot be "classified as stock in trade or property subject to inventory unless they [are] held by the taxpayer primarily for sale to customers in the ordinary course of his business." Tybus v. Commissioner, 1989 WL 68001 (U.S. Tax. Ct.), 57 T.C.M. (CCH) 796 (June 26, 1989) (quoting Van Suetendael v. Commissioner, 152 F.2d 654 (2d Cir. 1945). "Whether securities are held primarily for sale to customers is a question of fact, with the crucial phrase being 'to customers.'" Id.

Pike concedes that he is not a securities dealer, see Plaintiffs' Memorandum in opposition to Summary Judgment at 13, n.4, and it is undisputed that he amassed the bank stock for reasons other than for sale to customers in the ordinary course of business. Nonetheless, Pike argues that the stock constitutes "inventory" within the meaning of § 1221(1) because of the business purpose for which it was acquired, i.e., to obtain the financial leverage necessary to encourage individual banks to combine into a regional behemoth. See id. at 13-14. The argument is specious given the irrelevance of taxpayer's motive in acquiring an asset. In addition, the fact that the stock, had it increased in value, later could have been sold at a profit

does not classify it as non-capital inventory given the undisputed fact that Pike has never been a securities dealer. The court finds that the government properly treated Pike's stock as a "capital asset" under § 1221 for purposes of the 1989 tax return.

Conclusion

The court finds that the plaintiff's bank stock was a capital asset as defined in 26 U.S.C. § 1221. The government's motion for summary judgment (document no. 6) is granted. The clerk is ordered to close the case.

SO ORDERED.

/S/ Joseph A. DiClerico, Jr.
Chief Judge

November 28, 1995

cc: Eugene M. Van Loan III, Esquire
T. David Plourde, Esquire
Scott H. Harris, Esquire

APPENDIX C - ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT ENTERED AUGUST 28, 1996

UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

No. 95-2358

MILO L. PIKE AND PENNY P. PIKE,
Plaintiffs, Appellants
v.
UNITED STATES OF AMERICA
Defendant, Appellee

Before
Cyr, Circuit Judge.
Aldrich, Senior Circuit Judge
Gertner, * District Judge

ORDER OF THE COURT

Entered: August 28, 1996

The petition for rehearing is denied.

By The Court:

William H. Ng
Clerk.

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*Of the District of Massachusetts sitting by designation

[cc: Messrs. Van Loan, Dunn, Plourde, Harris, Allen, Cohen, Linguanati]